Republic of Kosovo: Letter of Intent, and Technical Memorandum of Understanding

December 5, 2012

The following item is a Letter of Intent of the government of Republic of Kosovo, which describes the policies that Republic of Kosovo intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Republic of Kosovo, is being made available on the IMF website by agreement with the member as a service to users of the IMF website.
Republic of Kosovo: Letter of Intent

Pristina, December 5, 2012

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington, DC 20431
U.S.A.

Dear Ms. Lagarde:

1. Kosovo’s economy has continued to display considerable resilience in the face of financial turbulence in the euro area. Limited export and financial linkages have constrained contagion, while current and capital inflows, notably from the Kosovar diaspora, have continued to support demand. Advances have been made in enhancing the business climate, acknowledged by the World Bank through an improvement in Kosovo’s ranking in the “Doing Business” report (see ¶18). The banking system has remained well-capitalized and liquid, despite a recent increase in non-performing loans (NPLs). Nevertheless, we remain vigilant to downside risks, including a possible deterioration in labor market conditions in the diaspora’s host countries that could, for example, be caused by a further intensification of the euro area crisis. In this challenging environment, we remain committed to disciplined fiscal management, the rebuilding of an adequate level of government bank balances, the strengthening of the legal and regulatory framework for Kosovo’s financial system, prudent financial supervision, and structural reforms to boost competitiveness.

2. Implementation of our economic program has remained broadly consistent with our commitments under the Stand-By Arrangement (SBA; Tables 1 and 2):

a. We have met all quantitative performance criteria for end-August. The primary fiscal balance and government bank balance were stronger than programmed, despite a modest shortfall in revenue relative to plan, owing to restraint on spending, higher-than-anticipated grant disbursements from the World Bank, the advancement of dividend payments from the telecommunications company (PTK), and the receipt of unconstrained transfers from the Kosovar Privatization Agency (PAK).

b. We have also met all structural benchmarks, although in one case with a slight delay.

(i) The end-August structural benchmark on launching the tender offer for PTK was met with a delay of 10 days, as more time was needed to evaluate the large number of companies that showed interest in the privatization. Five companies were admitted to the
final bidding. The winning bid for PTK is expected to be announced in January, and the transaction is anticipated to be settled in the first half of 2013.

- (ii) On October 31, we submitted a 2013 budget to the assembly that contains a primary deficit of €155 million (excluding PAK-related expenditures) and structural adjustment measures of €32 million, consistent with the corresponding structural benchmark. The assembly is expected to pass the budget in December (prior action).
- (iii) Also respected were the continuous structural benchmarks on monthly meetings of our Program Monitoring Committee, and on fiscal impact assessments evaluating the budgetary impact of all new benefit creating laws and amendments to such laws over a period of at least five years.

3. Based on this performance, we request completion of the second review under the Stand-By Arrangement, and a purchase of SDR 34.857 million following completion of the review. As we expect the government bank balance to return to or even exceed a fully adequate level with the anticipated completion of PTK privatization, and in view of the significant strengthening in policies under this SBA and the preceding Staff-Monitored Program, we intend to treat the Stand-By Arrangement as precautionary in 2013. Further, to better align subsequent program reviews with our budgetary calendar, we request the remaining access under the SBA (SDR 12.753 million) be re-phased in three purchases over the remainder of the program, with test dates of end-December 2012, end-April 2013, and end-August 2013.

4. We request that the performance criterion on the government bank balance be modified to reflect the unforeseen receipt of transfers from PAK in July, while leaving a buffer in the target to insure against unforeseen events. Quantitative performance criteria and indicative targets through end-August 2013 are set out in Table 2 and in the Technical Memorandum of Understanding, both attached to this letter.

5. We believe that the policies set forth in the letters of April 12, 2012, June 27, 2012 and in this letter are adequate for successful implementation of the program. However, the government stands ready to take additional measures as appropriate to ensure achievement of the program’s objectives. As is standard under all IMF arrangements, we will consult with the IMF before modifying measures contained in this letter or before the adoption of new measures that would deviate from the goals of the program, in accordance with the Fund’s policies on such consultations, and provide IMF staff with the necessary information for program monitoring. The third review is expected to be completed after February 28, 2013, the fourth review is expected to be completed after June 28, 2013, and the fifth review is expected to be completed after October 28, 2013. The understandings between us and the IMF regarding performance criteria and structural measures described in this letter are further specified in the Technical Memorandum of Understanding. We authorize the IMF to publish this letter and the associated staff report.
I. Macroeconomic Outlook

6. We have revised our macro-forecasts in response to continuing turmoil in the euro area and its impact on both external demand and current and capital inflows. However, growth is expected to remain stronger than in most neighboring countries. The macroeconomic framework underpinning our program is based on cautious assumptions to reflect unusually uncertain external conditions and to minimize the risk of downward revisions during the program period.

   a. We have marked down real GDP growth by about ½ of a percentage point for both 2012 and 2013 compared to our initial projections. We expect growth to recover to around potential growth from 2014, in line with projected developments in the euro area.

   b. Consumer price inflation is projected to be slightly above 2 percent this year (annual average), mostly reflecting developments of prices for imported food, but is expected to fall below 2 percent in 2013. We expect core inflation to remain subdued.

   c. We have revised upward the trade deficit to almost 40 percent both this year and next, reflecting weaker external demand and higher import prices, notably for food. We expect the deficit to be financed by current transfers, FDI, and other inflows, including from the Kosovar diaspora.

II. Fiscal Policy

A. Budget Execution in 2012

7. Fiscal policy remains guided by the objectives of fully achieving a sustainable fiscal stance and an adequate level of government bank balances. Execution of the 2012 budget has thus far been broadly in line with our program.

   a. Revenue collection was somewhat behind program targets at end-August, reflecting in part a different seasonality in collected revenues due to (i) unusually severe weather early in the year and (ii) an administrative change at the customs’ administration (receipts are now collected when they leave rather than enter the warehouse). We have seen improvements in revenue collection in September and October.

   b. The shortfall has been compensated by under-execution of spending, notably on non-highway capital projects.

   c. On current trends, we expect higher budget receipts (composed of revenue and financing) than at the time of the first review. However, within this envelope we anticipate a revenue shortfall of about €20 million by end-year. To ensure meeting of end-year performance criterion for the primary fiscal balance, we have pre-identified spending cuts of €24 million distributed across expenditure categories as follows: capital
spending (€15 million), subsidies and transfers (€2 million), goods and services (€5 million), and wages and salaries (€2 million, the latter reflecting unfilled vacancies).

8. We have conducted ten successful three-month treasury-bill auctions and two 6-month treasury-bill auctions this year, raising €74 million (net) at annualized yields of between 2 and 3 percent. We intend to issue bills with a maturity of 12 months in 2013, in an effort to lay the foundations for self-sustained budget financing, although variations to this schedule are possible depending on the absorptive capacity of the market.

B. The 2013 Budget

9. Consistent with our objective to gradually restore a sustainable fiscal stance, our 2013 budget targets a primary deficit (excluding PAK-related expenditures) of €155 million (3 percent of GDP). The budget law includes structural fiscal adjustment measures of €32 million (0.6 percent of GDP). Specifically, the 2013 budget contains the following parameters:

   a. *Revenue projections* are cautious and should be achievable even if nominal GDP growth would be as low as 5 percent, to ensure that revenue collection will remain on target even in case of negative shocks to growth. We also plan to raise one-off revenues of €50 million, composed of €30 million from another PTK dividend, and €20 million from the sale of telecommunication licenses.

   b. *Structural revenue measures* include an increase in lignite royalties (expected to raise €22 million) and an increase in airport licensing receipts (€4 million). The impact is partially offset by eliminating customs duties on some intermediate goods during the course of the year (€2 million), in an effort to strengthen the competitiveness of Kosovar producers of final goods.

   c. We will exercise *spending restraint across current spending categories*. At the same time, the budget accommodates the short-term costs of two important structural reforms: (i) health reform, which allows the government to contract services directly from hospitals, and (ii) civil service reform, which will establish a grading structure for public employees and has been developed in consultation with the World Bank. There is also a shift from capital to current spending triggered by municipalities making use of the greater flexibility granted in the 2013 budget to allocate non-wage current spending across spending categories.

   d. *The energy company KEK will start repaying the government in 2013 (in net terms)* in an amount of €6 million, which compares to sizeable positive net borrowing in previous years. We do not anticipate providing any further loans to KEK going forward. The ability of KEK to reduce its debt reflects structural improvements in revenue collection and tariff increases.
e. *Highway R7* to Albania will be completed in 2013. Further, the budget includes an allocation of €30 million (0.6 percent of GDP) to initiate highway R6 to Macedonia. The budget law will contain a clause that the allocation for the construction of R6 will be executed only once the government bank balance is at a level of at least €300 million.

f. As a *general contingency* for fiscal risks, the budget leaves €20 million unallocated, given the unusually uncertain economic outlook.

g. With this budget, the *government bank balance* is expected to exceed €400 million by end-2013, which is well above the adequate minimum level and provides a buffer to finance infrastructure projects in subsequent years, notably highway R6 to Macedonia.

**C. Highway R6 to Macedonia**

10. We intend to start the construction of highway R6 to Macedonia in 2013, in the context of our long-standing policy priority to improve Kosovo’s road network and integrate it into the regional network of highways in Southeastern Europe. However, several preconditions have to be in place before we would enter into contractual obligations with respect to R6. These include:

   a. *Integration into a sustainable budgetary framework.* We will start construction of highway R6 only once the government bank balance is close to a fully adequate level (see ¶9e above). To start construction in 2013, additional one-off revenues are needed to create fiscal space for R6 (¶9b above), reflecting the fact that in 2013 we will also be completing highway R7, which absorbs significant budgetary resources. From 2014, investments in R6 can be financed out of the regular budget envelope without putting undue pressure on the deficit, the government bank balance or on other priority spending, provided total costs for R6 remain within 15 percent of GDP and the realization of the project is stretched until 2016.

   b. *Economic viability.* An earlier feasibility study from 2011 suggested that the northern section of R6 of about 42 kilometers is economically viable, while the southern section of about 13 kilometers linking R6 to Macedonia is not, owing primarily to high construction cost in a mountainous terrain. We are preparing alternative, less expensive design options for the southern section that include replacing a tunnel with overland roads and a reduction in the number of traffic lanes. We will update the feasibility study with these design options and new traffic volume estimates, and send the feasibility study to IMF and World Bank staff by end-January 2013 (structural benchmark). The World Bank will thereafter seek to confirm in a timely manner that: (i) the feasibility study is in line with sound international practices, and (ii) the results show economic viability of R6. A positive assessment by the World Bank is a precondition for us to proceed with the tender for construction of R6. If the study fails to show economic viability, we may analyze additional design options.
c. **Openness and transparency of the bidding process.** We will ensure open and transparent bidding, including by (i) the use of FIDIC contracts, (ii) the timely engagement of supervision engineers, and (iii) the publication of contract documents consistent with legal requirements.

We will take stock in early 2013 as regards preparations for highway R6, and may discuss alternative financing arrangements with the IMF, should the need arise.

**D. Rules-Based Fiscal Framework**

11. We are preparing the introduction of a legally binding fiscal rule to anchor fiscal policy in the medium-to-long term. The rule will contain the following elements:

   a. **a ceiling on the overall deficit of the general government of 2 percent of GDP,** which is consistent with stabilizing the ratio of public debt over GDP at about 30 percent in the medium- to long-term. The space for deficits will be allocated between the central government and those municipalities entitled to accumulate debt according to their respective shares in general government spending.

   b. **full carryover** of budgetary under- and over-performance to future budgets (under-performance has to be compensated within three years).

   c. **an exemption of well- specified capital projects from the deficit ceiling,** as long as the projects are financed from non debt-creating sources (such as privatization receipts) and the government bank balance is at an adequate level.

The parameters of the fiscal rule would be revised every five years to take into account developments on potential growth, interest rates, etc. In case the government bank balance is at an inadequate level, and/or a 2 percent deficit cannot be financed without putting undue strains on the government paper market, deficits lower than 2 percent of GDP will be required.

12. In the coming months, we will draft the necessary legal changes to prepare the introduction of the rules-based fiscal framework. These could take the form either of amendments to the Law on Public Financial Management and Accountability (LPFMA), or of a new law. We will request technical assistance (TA) from the IMF to assist with the drafting of the legislation, following up on the TA mission that visited Pristina in June 2012 and developed a first set of proposals for a fiscal rule. We intend to submit legislation to the assembly by end-March 2013 (structural benchmark), such that it will be binding for the 2014 budget.

**E. Other Fiscal Issues**

13. Careful planning of spending initiatives remains at the core of our efforts to improve public financial management.
a. A revised Pillar I Pension Law is expected to be approved by the assembly in the coming months that includes increases of 33 percent for the basic pension and of 40 percent for the pension for contribute payers (retirees with a record of paying 15 years of contributions). These increases are included in the 2012 and 2013 budgets and are consistent with sustainability of the medium-term budgetary framework. Legislation on pensions for workers that were forcibly removed from their workplace in the 1990s, and/or differentiated pensions by profession and qualification, would only be introduced once fiscal impact assessments have been conducted.

b. Progress has been made as regards the preparation of possible benefits for war veterans and erstwhile political prisoners. Fiscal impact assessments covering a period of at least five years are expected to be completed in the first half of 2013.

14. We are developing an action plan to improve the recording and monitoring of payment obligations, with a view to avoiding domestic payments arrears.

a. We have set up a special unit within the treasury that is charged with monitoring arrears reporting and the level of arrears across all budgetary organizations.

b. We will engage in a publicity campaign that explains (i) the responsibilities of budgetary organizations when entering into contractual obligations, (ii) the definition of payment arrears, and (iii) enforcement sanctions for non-compliance as they are foreseen in the LPFMA.

c. We will enforce sanctions on officials contravening treasury expenditure control regulations after an infraction has been confirmed by the General Audit Office (GAO), and in line with the sanctions foreseen in the LPFMA. Further, the treasury will monitor the number cases submitted to the GAO for review, and the number of cases for which sanctions have been enforced.

We will analyze the need for further action in this area in the coming months, and will return to the issue during the next IMF review mission.

III. Financial Sector Policies

15. Kosovo’s financial system remains well-capitalized, profitable, and liquid. The banking system’s aggregate capital adequacy ratio stood at 17.7 percent at end-September, well above the regulatory minimum of 12 percent. Non-performing loans (NPLs) have continued to increase, however, reaching 7.0 percent in September, compared to 5.8 percent at end-2011, with the increase being concentrated in the corporate sector. Corrective actions include:

a. the central bank has stepped up data collection on loans’ terms and conditions, to improve its ability to discover misreported problem loans and request corrective action at an early stage;
b. the central bank is reassessing risks to banks’ external assets, including deposits held with other entities of a banks’ consolidated financial group. The exercise is expected to be completed by end-December. Based on the results of this exercise, the central bank will request prudential measures as needed. These may include raising provisions or risk weights for external exposures, higher required minimum capital adequacy requirements, and/or requesting advance notification for transfers with related external parties.

16. Corrective measures imposed on several commercial banks earlier this year have been almost fully implemented. The measures included—depending on the specific situation of each bank—republishing financial statements, injections of fresh capital, and the strengthening of governance, including by replacing members of some banks’ senior management and supervisory boards. Further, we will take action as needed to ensure that banks are in compliance with rules set by the new Law on Banks and Microfinance Institutions, including with respect to exposure limits to bank-related parties.

17. We are in the process of introducing amendments to the draft deposit insurance law (DIL) prior to its passage by the assembly. The amendments aim at providing greater clarity on some legal definitions, reducing the timeframe for repayment of insured depositors, and enhancing information sharing and collaboration between the deposit insurance fund and the central bank. The amendments also raise the maximum size of insured deposits. Specifically,

a. the DIL will specify that the maximum size of insured deposits will gradually raise from a starting level of €2000 to (i) €3000 by January 1, 2014; (ii) €4000 by January 1, 2016; and (iii) €5000 by January 1, 2018. However, these increases will be implemented only after the deposit insurance fund has received €6.4 million in funds committed but not yet disbursed by the government and other contributors. It is expected that coverage could increase further in the years after 2018—in line with Kosovo’s economic development and convergence of per-capita-GDP—which would bring the deposit insurance scheme closer in line with those of other countries in the region and in the European Union.

b. Article 27 of the DIL will specify that the deposit insurance fund will neither stop collecting bank premia nor reduce these premia except to reflect improvements in a bank’s risk profile, in line with Deposit Insurance Core Principles. It will also be formulated in a way that allows expanding the size of the target reserve fund to more than 5 percent of insured deposits. The deposit insurance fund will issue a regulation to establish a working size of the fund equivalent to 8 to 9 percent of insured deposits.

IV. COMPETITIVENESS AND STRUCTURAL REFORMS

18. Our efforts to strengthen the business environment and investment climate have yielded an improvement of Kosovo’s ranking in the World Bank’s Doing Business report from #117 in 2011 to #98 in 2012. In this context, eleven laws have been passed out of a package of twelve
laws that aim at reducing the costs of setting up business, unifying business registries, and simplifying the licensing system. The remaining law on execution procedure has been drafted and submitted to the assembly for approval.

19. Two additional laws on telecommunication and mining sectors have been drafted, and the law on telecommunications has already been passed by the assembly. Their objective is to remove entry barriers and ensure equal treatment among investors. Furthermore, we are finishing preparatory work for a project on promoting the development of SMEs, jointly with the Austrian Development Agency and the Swiss Office for Cooperation. To foster the development of the agriculture sector, we have expanded an agricultural loan program to €20 million, supported by guarantees from USAID, to improve the sector’s access to long-term capital.

20. The report on the implementation of the Labor Law with an emphasis on maternity leave provisions has been finalized. Based on the report’s findings, we intend to reduce the maternity leave period from 12 months to 6-9 months, to prevent discrimination against women in the labor market.

Sincerely yours,

/s/

Hashim Thaçi
Prime Minister

/s/

Bedri Hamza
Minister of Finance

/s/

Gani Gërguri
Governor, Central Bank of the Republic of Kosovo
### Table 1. Kosovo: Program Monitoring

<table>
<thead>
<tr>
<th>Performance criteria</th>
<th>Program Approval</th>
<th>End-April 2012</th>
<th>End-August 2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Floor on the bank balance of the general government</td>
<td>…</td>
<td>Met</td>
<td>Met</td>
</tr>
<tr>
<td>Floor on the primary fiscal balance of the general government</td>
<td>…</td>
<td>Met</td>
<td>Met</td>
</tr>
<tr>
<td>Ceiling on primary expenditures of the general government</td>
<td>…</td>
<td>Met</td>
<td>Met</td>
</tr>
<tr>
<td>Ceiling on the net contracting of nonconcessional debt by the general government</td>
<td>…</td>
<td>Met</td>
<td>Met</td>
</tr>
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</table>

<table>
<thead>
<tr>
<th>Indicative targets</th>
<th></th>
<th>Missed</th>
<th>Missed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ceiling on the stock of domestic payment arrears of the central government</td>
<td>…</td>
<td>Missed</td>
<td>Missed</td>
</tr>
<tr>
<td>Ceiling on the stock of domestic payment arrears of the general government</td>
<td>…</td>
<td>Missed</td>
<td>Missed</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Prior actions</th>
<th></th>
<th>Met</th>
<th>…</th>
</tr>
</thead>
<tbody>
<tr>
<td>Passage of the Pension Fund Law in a version that limits (i) exposure of the pillar II pension fund to the government to 30 percent of the fund's assets and (ii) annual investments of the fund in government paper to 50 percent of inflows into the fund in the previous calendar year</td>
<td>Met</td>
<td>…</td>
<td>…</td>
</tr>
<tr>
<td>Passage of the revised Banking and Microfinance Law in a version consistent with the recommendations of IMF technical assistance</td>
<td>Met</td>
<td>…</td>
<td>…</td>
</tr>
<tr>
<td>Issuance of a government decision that specifies spending cuts of €20 million across expenditure categories relative to the approved 2012 budget</td>
<td>Met</td>
<td>…</td>
<td>…</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Structural benchmarks</th>
<th></th>
<th>Met</th>
<th>…</th>
</tr>
</thead>
<tbody>
<tr>
<td>Publication of budget circulars for municipalities that contain no limits on spending allocations across non-wage categories (by end-May, 2012)</td>
<td>…</td>
<td>Met</td>
<td>…</td>
</tr>
<tr>
<td>Submission of a revised Deposit Insurance Fund Law to the Assembly that is consistent with the new Banking and Microfinance Law (by end-May, 2012)</td>
<td>…</td>
<td>Met with delay</td>
<td>…</td>
</tr>
<tr>
<td>Amendment of the Law on Public Financial Management and Accountability by a provision that specifies that only the central bank can dispose over the funds in the Special Reserves Fund designated for Emergency Liquidity Assistance (by June 15, 2012)</td>
<td>…</td>
<td>Met</td>
<td>…</td>
</tr>
<tr>
<td>Launch of the tender offer for PTK (by end-August, 2012)</td>
<td>…</td>
<td>…</td>
<td>Met with delay</td>
</tr>
<tr>
<td>Submission of a 2013 budget consistent with the objectives of the program to the Assembly (by end-October, 2012).</td>
<td>…</td>
<td>…</td>
<td>Met</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Continuous structural benchmarks</th>
<th></th>
<th>Met</th>
<th>…</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monthly meetings of the Program Monitoring Committee and transmission of meetings’ minutes to the IMF Resident Representative</td>
<td>…</td>
<td>Met</td>
<td>Met</td>
</tr>
<tr>
<td>Inclusion of a paragraph into all new benefit creating laws, amendment to laws or regulations that allows cutting benefits if budgetary funds are unavailable 1/</td>
<td>…</td>
<td>Not met</td>
<td>…</td>
</tr>
<tr>
<td>Fiscal impact assessments evaluating the budgetary impact of all new benefit creating laws, amendments to such laws or regulations over a period of at least 5 years</td>
<td>…</td>
<td>Met</td>
<td>Met</td>
</tr>
</tbody>
</table>

1/ Eliminated after the first review following a corresponding amendment of the Law on Public Financial Management and Accountability.
Table 2. Kosovo: Quantitative Performance Criteria and Indicative Targets, 2012–13
(Millions of euros; flows cumulative from beginning of the year)

<table>
<thead>
<tr>
<th>Performance Criteria 1/</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Floor on the bank balance of the general government 2/</td>
<td>-21 4</td>
<td>-26 -19</td>
</tr>
<tr>
<td>Ceiling on primary expenditures of the general government 3/</td>
<td>399 353</td>
<td>911 911</td>
</tr>
<tr>
<td>Ceiling on the net contracting of nonconcessional debt by the general government 3/</td>
<td>150 30</td>
<td>150 150</td>
</tr>
<tr>
<td>Ceiling on guaranteeing nonconcessional debt by the general government 3/</td>
<td>0 0</td>
<td>0 0</td>
</tr>
<tr>
<td>Ceiling on the accumulation of external payments arrears of the general government 4/</td>
<td>0 0</td>
<td>0 0</td>
</tr>
</tbody>
</table>

Indicative Targets
- Ceiling on the stock of domestic payment arrears of the central government: 0 2 0 0 0.3 0 0 0 0
- Ceiling on the stock of domestic payment arrears of the general government: 0 2 0 0 3 0 0 0 0

Memorandum items:

Program assumptions
- Repayment of policy loans extended to public corporations: 4 4 4 4 4 4 2 4 4
- Non-project grants: 4 1 30 37 37 30 37 0 0
- Budget support loans: 0 0 0 0 0 0 0 0 0
- Project grants: 1 0 3 3 0 4 4 1 2
- Project loans: 0 0 6 6 0 7 7 1 3
- PAK-related spending: 5 5 4 8 8 2 5

Sources: Kosovo authorities; and IMF staff estimates and projections.

1/ Adjusted according to the Technical Memorandum of Understanding.
2/ The end-August and end-December, 2012 PCs have been adjusted to reflect higher than expected budget grants relative to program assumptions, as specified in the TMU.
3/ Excluding PAK related spending from August 2012.
4/ Continuous ceiling on the gross flow of new accumulation.

Table 3. Kosovo: Structural Conditionality

<table>
<thead>
<tr>
<th>Actions</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prior action</td>
<td>Passage of the 2013 Budget Law by the Assembly, consistent with the objectives of the program.</td>
</tr>
<tr>
<td>Structural benchmarks</td>
<td>Submission of an economic viability study for highway R6 to the World Bank and IMF staff.</td>
</tr>
<tr>
<td></td>
<td>Submission of legislation to the assembly on the Rules-Based Fiscal Framework that is consistent with para 11 of this Letter of Intent.</td>
</tr>
<tr>
<td></td>
<td>Monthly meetings of the Program Monitoring Committee and transmission of meetings’ minutes to the IMF.</td>
</tr>
<tr>
<td></td>
<td>Fiscal impact assessments evaluating the budgetary impact of all new benefit creating laws, amendments to such laws or regulations over a period of at least 5 years.</td>
</tr>
</tbody>
</table>
Technical Memorandum of Understanding
Definitions and Data Reporting Requirements under the 2012–13 Stand-By
Arrangement

1. This Technical Memorandum of Understanding (TMU) sets out the understandings
between the Kosovo authorities and the IMF staff regarding the definition of quantitative
performance criteria and indicative targets, and reporting requirements for the Stand-By
Arrangement ("SBA") requested in April 2012.

I. PERFORMANCE CRITERIA AND INDICATIVE TARGETS

A. Coverage

2. For the purpose of this memorandum, the central government is composed of the
Executive, the Legislative, and Judiciary branches of the Government, and any other public
authorities except municipalities that receive direct budgetary appropriations. The general
government includes the central government and municipalities. Both the central and the
general government exclude publicly owned enterprises and socially owned enterprises.

3. Performance Criteria and Indicative Targets. The performance criteria, indicative
targets, and their respective test dates are set in Table 2 of the Letter of Intent (LOI).

B. Bank Balances of the General Government

4. Bank balances are funds usable and readily available (i.e., liquid or marketable, and
free of any pledges or encumbrances), held and controlled by the general government for the
purposes of making payments and transfers. Bank balances include Undistributed Funds of
the Government of Kosovo plus funds specifically reserved for policy purposes including
emergency liquidity assistance but do not include the balance of unspent Own Source
Revenues (OSR) carried forward, or funds encumbered or pledged as Donor Designated
Funds and funds relative to on lending operations. Bank balances do not include investments
made and managed by an outside Investment Manager assigned by the Minister pursuant to
Kosovo’s Law on Public Financial Management Article 7.1.(iii). Bank balances may be held
in the form of gold, holdings of foreign exchange and traveler’s checks, demand and short-
term deposits at the Central Bank of the Republic of Kosovo (CBK), long-term deposits
abroad that can be liquidated without penalty, and any holdings of investment-grade
securities held directly by the general government. Bank balances at December 31, 2011,
were €159,986 million.

- The floor on the bank balance set in Table 2 will be raised by:
• the excess of budget grants and loans relative to program assumptions

• the excess of privatization proceeds, including from the telecommunication company (PTK) and the receipt of transfers from the Privatization Agency of Kosovo (PAK) relative to program assumptions

5. **Reporting requirements.** A table on bank balances will be transmitted by the Treasury with a maximum delay of five weeks after the end of each month. In addition, the CBK will submit twice a month, with a delay of 1 day, the Report of Positions of Treasury Accounts. Within 45 days after each test date, the CBK will submit to the IMF the independent audit of the reconciliation of government accounts.

C. **Primary Expenditures of the General Government**

6. **Primary expenditures** are measured on a cash basis cumulatively from the beginning of the calendar year. Expenditures of the Privatization Agency of Kosovo (PAK) are excluded. Primary expenditures include current expenditures (wages and salaries, goods and services, subsidies and transfers, reserves), capital expenditures, and net lending. They do not include interest payments or receipts or expenditures designated by donors financed with grants (“donor designated grants”). Net lending comprises loans granted by the general government except that it does not include onlending such as funds borrowed from KfW, which is instead included as a domestic financing item (“below the line”). All expenditures and net lending financed with loans to be serviced by the general government are in the program’s concept of expenditures and net lending, even if the cash did not transit through the Treasury.

• The ceiling on primary expenditures set in Table 2 will be raised by the excess of project grants and loans relative to program assumptions.

• The ceiling on primary expenditures set in Table 2 will be lowered by:
  • the shortfall of project grants and loans relative to program assumptions.
  • the repayment of loans extended to public corporations in excess of program assumptions.

7. For the purposes of this memorandum, **proceeds of privatizations** will be understood to mean all monies received by the government from the sale of a publicly owned company, organization, or facility to a private company or companies, organization(s), or individual(s), as well as any proceeds generated from the sale of government nonfinancial assets and from the liquidation of the assets of the Privatization Agency of Kosovo (PAK). Proceeds of
privatizations are not part of revenues. Instead, these are recorded as a domestic financing (Net acquisition of financial assets).

8. **Reporting requirements.** Data on the monthly execution, budget appropriations, and budget allocations of revenues and expenditures will be provided monthly no later than five weeks after the end of each month, including (i) government domestic revenue detailing by components direct taxes, indirect taxes, and nontax revenues; (ii) external budget support grants; (iii) primary recurrent expenditure, (iv) domestic and external interest payments and receipts, (v) capital expenditure detailing all those related to the construction of Route 7 and Route 6, and including domestically and budget support financed capital expenditure and externally project financed capital expenditure; (vi) the gross payment and gross accumulation of domestic payments arrears; (vii) external loan receipts and principal payments; (viii) external arrears payments and accumulation; (ix) bank and nonbank financing; (x) privatization and receipts of the sales of nonfinancial assets; and (xi) any other revenue, expenditure, or financing not included above.

**D. Primary Fiscal Balance of the General Government**

9. **Primary fiscal balance** of the general government is defined as revenues and grants minus primary expenditures cumulatively since the beginning of the calendar year. Expenditures of the Privatization Agency of Kosovo (PAK) are excluded. Revenues do not include privatization receipts.

- The floor on the primary fiscal balance set in Table 2 will be lowered by the excess in project loans relative to program assumptions.
- The floor on the primary fiscal balance set in Table 2 will be raised by
  - the shortfall in project loans relative to program assumptions
  - the excess in budget grants relative to program assumptions.

**E. Contracting and Guaranteeing Nonconcessional Debt by the General Government**

10. **Nonconcessional debt** is defined as debt contracted or guaranteed by the general government with a grant element of less than 35 percent. The grant element of a debt is the difference between the present value (PV) of debt and its nominal value, expressed as a percentage of the nominal value of the debt. The PV of debt at the time of its contracting is calculated by discounting the future stream of payments of debt service due on this debt. The discount rates used for this purpose are the using currency-specific commercial interest reference rates (CIRRs) published by the Development Assistance Committee of the Organization for Economic Cooperation and Development (OECD). For debt with a maturity
of at least 15 years, the ten-year-average CIRR will be used to calculate the PV of debt and, hence, its grant element. For debt with a maturity of less than 15 years, the six-month average CIRR will be used. To both the ten-year and six-month averages, the same margins for differing repayment periods as those used by the OECD need to be added (0.75 percent for repayment periods of less than 15 years, 1 percent for 15 to 19 years, 1.15 percent for 20 to 29 years, and 1.25 percent for 30 years or more).

11. The ceilings on contracting and on guaranteeing nonconcessional debt cover both domestic and external debt, but exclude purchases from the IMF and the sale of the SDR holdings allocated to Kosovo. Debt rescheduling and debt reorganization of debts contracted before the approval of the SBA are excluded from the limits on nonconcessional debt. The quantitative performance criteria apply not only to debt as defined below but also to commitments contracted or guaranteed for which value has not been received. The contracting or guaranteeing nonconcessional debt by the general government will be assessed at each test date.

12. The government of Kosovo will consult with Fund staff before contracting or guaranteeing any new debts in circumstances where they are uncertain whether the instrument in question is covered under the quantitative performance criterion.

13. **Definition of debt.** The definition of debt is set out in Executive Board Decision No. 12274-(00/85), Paragraph 9, as amended on August 31, 2009 (Decision No. 14416-(09/91)):

“(a) For the purpose of this guideline, the term “debt” will be understood to mean a current, i.e., not contingent, liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being as follows:

“(i) loans, i.e., advances of money to the obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans and buyers’ credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements);
“(ii) suppliers’ credits, i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided; and

“(iii) leases, i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lessor retains the title to the property. For the purpose of the guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair or maintenance of the property.

“(b) Under the definition of debt set out in this paragraph, arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt.”

14. **Reporting requirements.** Details of all new debt taken or guaranteed, indicating terms of debt and creditors, will be provided on a quarterly basis within five weeks of the end of each quarter.

F. **Domestic Payments Arrears**

15. A domestic payment obligation to suppliers or creditors is deemed to be in **arrears** if:
(a) goods and services have been received; (b) they have been certified to conform to the order of the contract; and (c) the obligation has remained unpaid for more than 60 days after the invoice was received. A payment obligation is defined to be domestic if the creditor is resident in Kosovo.

16. **Reporting requirements.** The Ministry of Finance will submit a monthly table with the stock of domestic payments arrears and not in arrears. The data are to be provided within five weeks after the end of the month.

G. **External Payments Arrears**

17. **External arrears** are defined as total external debt service obligations of the government that have not been paid by the time they are due (after the expiration of the relevant grace period). External arrears exclude external debt service obligations subject to ongoing good faith negotiations of debt-rescheduling agreements. A debt service obligation is defined to be external if the creditor is not resident in Kosovo.
18. **Reporting requirements.** The Ministry of Finance will inform the Fund staff immediately of any accumulation of external arrears. Data on (i) debt-service payments; and (ii) external arrears accumulation and payments will be transmitted on a quarterly basis by the Ministry of Finance within five weeks of the end of each quarter.

**II. Other Data Requirements**

19. The monthly monetary statistics (including balance sheets and monetary surveys) of the CBK, the consolidated commercial banks and revisions to historical data (if any) will be transmitted on a monthly basis with a maximum delay of five weeks.

20. Data on exports and imports, including volume and prices and compiled by the Statistical Office of Kosovo (SOK), will be transmitted on a quarterly basis within forty-five days after the end of each quarter.

21. A preliminary quarterly balance of payments, compiled by the CBK, will be forwarded within three months after the end of each quarter.

22. The table of Financial Soundness Indicators and the regulatory capital and liquidity ratios of individual banks will be transmitted by the CBK to the IMF on a monthly basis within six weeks after the end of each month.

23. A monthly report on the number of employees will be transmitted to the IMF by the Treasury Department of the Ministry of Finance within two weeks after the end of each month.